



SECURITIES AND EXCHANGE COMMISSION
[Release No. 34-80270; File No. SR-CBOE-2016-082]

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change Related to Rules Regarding the Responsibility for Ensuring Compliance with Priority and Allocation Requirements and Trade-Through Prohibitions in Open Outcry Trading
March 17, 2017

I. Introduction

On December 1, 2016, the Chicago Board Options Exchange, Incorporated (the “Exchange” or “CBOE”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to amend Exchange rules regarding responsibility for ensuring compliance with open outcry priority and allocation requirements and trade-through prohibitions. The proposed rule change was published for comment in the Federal Register on December 19, 2016.³ The Commission received two comments on the proposed rule change, plus a response letter from CBOE.⁴ On January 31, 2017, pursuant to Section 19(b)(2) of the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 79540 (December 13, 2016), 81 FR 91967 (“Notice”).

⁴ See Letter to Brent J. Fields, Secretary, Commission, from Joan C. Conley, Senior Vice President and Corporate Secretary, Nasdaq, dated December 22, 2016 (“Nasdaq Letter”) and Letter to Brent J. Fields, Secretary, Commission from Steve Crutchfield, Head of Market Structure, CTC Trading Group, LLC; Kevin Coleman, Chief Compliance Officer, Belvedere Trading LLC; Scott Kloin, Chief Compliance Officer, Citadel Securities LLC; Steven Gaston, Chief Compliance Officer, Consolidated Trading LLC; Rob Armour, Chief Compliance Officer, DRW Securities, LLC; John Kinahan, Chief Executive Officer, Group One Trading L.P.; Daniel Overmyer, Chief Compliance Officer, IMC Financial Markets; Steven Gaston, Chief Compliance Officer, Lamberson Capital LLC; and Patrick Hickey, Head of Market Structure, Optiver US LLC, dated February 16, 2017 (“Market Makers Letter”). See also Letter to Brent J. Fields, Secretary, Commission,

Exchange Act,⁵ the Commission designated a longer period within which to approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to disapprove the proposed rule change.⁶

The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and to institute proceedings under Section 19(b)(2)(B) of the Exchange Act⁷ to determine whether to approve or disapprove the proposed rule change, as discussed in Section III below. The institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved, nor does it mean that the Commission will ultimately disapprove the proposed rule change. Rather, as described in Section III below, the Commission seeks and encourages interested persons to provide additional comment on the proposed rule change in order to inform the Commission's analysis of whether to approve or disapprove the proposed rule change.

II. Summary of Proposal

A. Description of Proposal

According to the Exchange, currently, if a transaction executed on the trading floor is executed at a price that violates the priority and allocation provisions of 6.45A(b) and 6.45B(b) ("Book Priority") or the trade-through prohibitions set forth in CBOE Rule 6.81 ("Trade-

from Kyle Edwards, Counsel, CBOE, dated March 14, 2017 ("CBOE Response Letter"). The comment letters and CBOE's response are available at <https://www.sec.gov/comments/sr-cboe-2016-082/cboe2016082.shtml>.

⁵ 15 U.S.C. 78s(b)(2).

⁶ See Securities Exchange Act Release No. 79910, 82 FR 9464 (February 6, 2017). The Commission designated March 19, 2017, as the date by which the Commission shall either approve or disapprove, or institute proceedings to determine whether to disapprove, the proposed rule change.

⁷ 15 U.S.C. 78s(b)(2)(B).

Through”), the Exchange enforces the violations against both parties to the transaction.⁸ Under the proposed rule change, with respect to an open outcry transaction between a Floor Broker and a Market-Maker, only the party that initiated the transaction on the trading floor would be held responsible for Book Priority and Trade-Through violations.⁹ With respect to an open outcry transaction between a Floor Broker and another Floor Broker, or a Market-Maker and another Market-Maker, the Exchange would hold both parties responsible for Book Priority and Trade-Through violations, consistent with the Exchange’s current practice.¹⁰

The Exchange observes that generally, Floor Brokers initiate transactions on the Exchange’s trading floor by representing orders and executing the orders against bids and offers of other in-crowd market participants, including Market-Makers.¹¹ The Exchange asserts that when Floor Brokers trade with Market-Makers, the Floor Brokers are in a better position to prevent Trade-Through and Book Priority violations because, unlike Market-Makers, Floor Brokers have access to the Public Automatic Routing System (“PAR”) offered by CBOE that provides Floor Brokers with the necessary market data to avoid Trade-Through and Book Priority violations, as well as provides alerts that warn Floor Brokers in advance that a proposed execution price for a given order may violate Book Priority rules or result in a potential Trade-Through.¹² The Exchange states that generally, a Floor Broker will verbally communicate a request for quote for a given order to the trading crowd, and the Market-Makers will then

⁸ See Notice, supra note 3, at 91968.

⁹ See proposed Interpretation and Policy .05 to Rule 6.45A, Interpretation and Policy .06 to Rule 6.45B, and Interpretation and Policy .07 to Rule 6.73.

¹⁰ See id. See also Notice, supra note 3, at 91969.

¹¹ See Notice, supra note 3, at 91968.

¹² See id. at 91969.

provide a responsive quote without the aid of PAR.¹³ The Exchange states that Market-Makers evaluate a Floor Broker's request for a quote against the Market-Maker's theoretical values for the given options series, a process which the Exchange observes becomes increasingly complicated when there are multiple options series that must be evaluated for a complex order.¹⁴ The Exchange asserts that it is therefore reasonable for a Market-Maker to rely on the Floor Broker initiating a trade to ensure that an open outcry transaction is executed in accordance with the Book Priority and Trade-Through provisions.¹⁵

The Exchange represents that this rule change, consistent with the Options Intermarket Linkage Plan,¹⁶ is reasonably designed to prevent Trade-Throughs, as well as Book Priority violations, because it would place the responsibility for ensuring transactions are executed in accordance with the Exchange's rules on the "specific party or parties in a good position to ensure compliance."¹⁷ The Exchange also believes that the proposed rule change "may help limit the number of [Book Priority] and Trade-Through violations because the proposal identifies a particular party or parties to each transaction (as opposed to all parties) as responsible for ensuring compliance with the rules."¹⁸

¹³ See id.

¹⁴ See id.

¹⁵ See id. In the event a Market-Maker initiates a transaction with a Floor Broker, the Market-Maker would be responsible for ensuring that the transaction is executed in accordance with the Book Priority and Trade-Through provisions. See id.

¹⁶ See generally Securities Exchange Act Release No. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000) (Order approving Options Intermarket Linkage Plan).

¹⁷ See Notice, supra note 3, at 91969.

¹⁸ See id.

B. Summary of Comments

As previously noted, the Commission received two comment letters on the proposed rule change, and a response from CBOE.¹⁹ One commenter states that it neither supports nor opposes the Exchange's proposal,²⁰ and the other commenter expresses support for the proposed rule change.²¹

One commenter suggests that the Exchange explain how PAR operates, and how the Exchange validates trades and conducts surveillances for purposes of regulating Book Priority and Trade-Through violations.²² In addition, the commenter suggests that the Commission articulate a principle of governing enforcement of book priority and trade-through requirements to floor trading in standardized options.²³ Though beyond the scope of CBOE's proposal, the commenter believes that disparities between how markets enforce these requirements could impact intramarket and intermarket competition.²⁴

Other commenters (in a joint letter submitted by nine CBOE market participants) support the proposal and assert that the proposed rule change seeks to assign responsibility for ensuring compliance with open outcry priority and allocation requirements and trade-through prohibitions in a "fair, reasonable, and logical manner," particularly in the case of an open-outcry trade initiated by a Floor Broker and responded to by a Market-Maker, because Market-Makers "generally lack access to" the tools and alerts CBOE offers to Floor Brokers that help assure

¹⁹ See supra note 4.

²⁰ See Nasdaq Letter, supra note 4.

²¹ See Nasdaq Letter, supra note 4. See Market Makers Letter, supra note 4.

²² See Nasdaq Letter, supra note 4, at 3.

²³ See id. at 4.

²⁴ See id. at 3.

compliance with those rules.²⁵ The commenters observe that pursuant to the Exchange's rules, it is a Floor Broker's responsibility to use due diligence to execute an order at the best price available, and to ascertain whether a better price than the one displayed is being quoted by another party, and that therefore, a Market-Maker should be able to assume that the Floor Broker has cleared the customer limit order book of any order at a better price in accordance with applicable rules.²⁶ The commenters assert that "the Floor Broker - as the party controlling the precise timing of any execution he or she initiates - is definitively in the best position to ascertain whether a Trade-Through or other rule violation would occur up to the instant of trade consummation, and should therefore appropriately hold sole responsibility for compliance with the applicable rules."²⁷ The commenters believe that by clearly allocating this responsibility, the proposal would remove impediments to and better align with the mechanism of a free and open market.²⁸

In its response letter, the Exchange asserts that the Nasdaq Letter does not address the substance of the proposal but rather offers general comment regarding open outcry trading.²⁹ In addition, in response to the Nasdaq Letter, the Exchange notes that its proposal does not describe how PAR operates or its surveillance parameters because this information is described in its rules.³⁰

²⁵ See Market Makers Letter, supra note 4, at 1-2. In addition, the commenter asserted that the issues raised by the Nasdaq letter "have no bearing on" the Exchange's proposal. See id.

²⁶ See id. at 2.

²⁷ See id.

²⁸ See id.

²⁹ See CBOE Response Letter, supra note 4, at 1.

³⁰ See id. at 3.

III. Proceedings to Determine Whether to Approve or Disapprove SR-CBOE-2016-082 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Exchange Act³¹ to determine whether the proposed rule change should be approved or disapproved. Institution of such proceedings is appropriate at this time in view of the legal and policy issues raised by the proposed rule change. Institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, as stated below, the Commission seeks and encourages interested persons to provide comments on the proposed rule change to inform the Commission's analysis of whether to approve or disapprove the proposed rule change.

Pursuant to Section 19(b)(2)(B) of the Exchange Act,³² the Commission is providing notice of the grounds for disapproval under consideration, as discussed below. The Commission believes that instituting proceedings will allow for additional analysis of, and input from commenters with respect to, the proposed rule change's consistency with Section 6(b)(1) of the Exchange Act, which requires that a national securities exchange is so organized and has the capacity to be able to carry out the purposes of the Exchange Act and to comply, and to enforce compliance by its members and persons associated with its members, with the provisions of the Exchange Act, the rules and regulations thereunder, and the rules of the exchange.³³

The Commission also is instituting proceedings to allow for additional analysis and input concerning the proposed rule change's consistency with Section 6(b)(5) of the Exchange Act,³⁴ which requires that the rules of a national securities exchange be designed, among other things,

³¹ 15 U.S.C. 78s(b)(2)(B).

³² Id.

³³ 15 U.S.C. 78f(b)(1).

³⁴ 15 U.S.C. 78f(b)(5).

to promote just and equitable principles of trade and, in general, to protect investors and the public interest and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

Specifically, the Commission is concerned whether the proposed rule change could adversely impact the ability of the Exchange, consistent with Section 6(b)(1) of the Exchange Act, to comply, and to enforce compliance by its members on the CBOE trading floor, with applicable rules and regulations, including the Book Priority and Trade-Through provisions. In particular, the Commission wishes to consider further whether CBOE has sufficiently demonstrated how absolving from liability for Book Priority and Trade-Through rule violations one party to a trade (i.e., the responder, for trades involving a Floor Broker on one side and a Market Maker on the other) while placing sole liability on the other party (i.e., the initiator, for trades involving a Floor Broker on one side and a Market Maker on the other) will foster compliance with those rules by its members and not diminish the Exchange's ability to ensure compliance with these critically important rules.

Further, the Exchange's stated justification for its proposal, which relies on the control an initiator has over the execution and price of the order as well as the fact that CBOE supplies its Floor Brokers with a system (PAR) that helps automate the necessary pre-trade checks, appears inconsistent with continuing to hold both parties to a trade liable when the trade is between two Market Makers or two Floor Brokers. Similarly, the proposal raises questions under Section 6(b)(5) of the Exchange Act, in that not enforcing Trade-Through and Book Priority violations against a party based on the identity of its counter-party (i.e., not enforcing against the responder when a Market-Maker trades with a Floor Broker, but enforcing against both parties when a

Market-Maker trades with a Market-Maker or a Floor Broker trades with a Floor Broker) may be unfairly discriminatory.

IV. Procedure: Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the issues identified above, as well as any other concerns they may have with the proposal. In particular, the Commission invites the written views of interested persons concerning whether the proposal is consistent with Sections 6(b)(1), 6(b)(5), or any other provision of the Exchange Act, or the rules and regulations thereunder. Although there do not appear to be any issues relevant to approval or disapproval that would be facilitated by an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4, any request for an opportunity to make an oral presentation.³⁵

Interested persons are invited to submit written data, views, and arguments regarding whether the proposal should be approved or disapproved by [insert date 21 days from publication in the Federal Register]. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by [insert date 35 days from publication in the Federal Register]. The Commission asks that commenters address the sufficiency of the Exchange's statements in support of the proposal, in addition to any other comments they may wish to submit about the proposed rule change.

³⁵ Section 19(b)(2) of the Exchange Act, as amended by the Securities Act Amendments of 1975, Pub. L. 94-29 (June 4, 1975), grants the Commission flexibility to determine what type of proceeding – either oral or notice and opportunity for written comments – is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Act Amendments of 1975, Senate Comm. on Banking, Housing & Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 30 (1975).

Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-CBOE-2016-082 on the subject line.

Paper comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Numbers SR-CBOE-2016-082. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of these filings also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer

to File Number SR-CBOE-2016-082 and should be submitted on or before [INSERT DATE 21 DAYS FROM PUBLICATION IN THE FEDERAL REGISTER]. Rebuttal comments should be submitted by [INSERT DATE 35 DAYS FROM DATE OF PUBLICATION IN THE FEDERAL REGISTER].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³⁶

Eduardo A. Aleman
Assistant Secretary

³⁶ 17 CFR 200.30-3(a)(57).

